Supreme Court, U.S.
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No. 97-1825

In the Supreme Court of the United States

OCTOBER TERM, 1997

REBECCA ISQUITH,
Petitioner,
v.
CAREMARK INTERNATIONAL, INC., ET AL.,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTION PRESENTED

1. Whether petitioner, a shareholder of Baxter International Inc., purchased or sold securities for purposes of section 10(b) of the Securities Exchange Act of 1934 when Baxter distributed all of the shares of its wholly-owned subsidiary Caremark International, Inc. *pro rata* to its shareholders, including petitioner, in a "spinoff."

LIST OF PARTIES

The parties to this case are petitioner, Rebecca Isquith, by her custodian, Fred T. Isquith, and respondents Caremark International, Inc., Baxter International Inc., C.A. Lance Piccolo, James G. Connelly, III, and Thomas W. Hodson.

RULE 29.6 STATEMENT

Baxter International Inc. ("Baxter") has no parent company. The following is a list of the direct and indirect nonwholly owned subsidiaries of Baxter:

Sheridan II Leasing Corporation
Interact Medical Technologies Corporation
HCPB/BSI Healthcare Systems (a partnership)
Consortium for Plasma Sciences, LLC
Nexell Therapeutics Inc.
Renal Management Strategies Inc.
Supercytes North America (L.P.)
Clintec GmbH & Company OHG
PAS Palzer Vervaltungs GmbH (LLC)
Plasti-Esteril S.A. de C.V.
Baxter Healthcare (Guangzhou) Company Ltd.
Baxter Healthcare (Shanghai) Company Ltd.
P.T. Pfrimmer Infusal
Baxter SpA
BM Tianjin Ltd.
Eczacibasi-Baxter Hastane Urunleri Sanayi ve Tricaret A.S.
Immuno SA
Gleneagles Dialysis Centre Pte. Ltd.
Gleneagles Dialysis International Pte Ltd
Healthcare Dialysis Centre Sdn Bhd
Wellcare Dialysis Centre Pte Ltd

Renal Center-Petaling Jaya (Malaysia)
Centre Nephrologigue du Centre S.A.
Renal S.A.
Unidad Renal del Tolima Ltda.
Centro de Terapia Renal Medelin Ltda.
Servico del Terapia Renal Cruz Roja Ltda.
Nefrologica Ltda.
Nefro Salud Ltda.
Instituto de Nefrologia AFFB SRL
Centro de Hemodialisis Temperly SRL
Renal Therapy Service S.A.
Daomi S.A.
Cendyt S.A.
Nefrologia Olivos S.A.
RTS Comerciale e Administracao Ltda.

Prior to the spinoff at issue in this case, Caremark International, Inc. ("Caremark") was a wholly-owned subsidiary of Baxter. Currently, Caremark's parent company is MedPartners, Inc. Caremark has no nonwholly owned subsidiaries.

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RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-12a) is reported at 136 F.3d 531 (7th Cir. 1998). The opinion of the district court (Pet. App. 13a-27a) is unreported.

JURISDICTION

The judgment of the Court of Appeals was entered on February 10, 1998. The petition for writ of certiorari was filed on May 11, 1998. Petitioner invokes the jurisdiction of this Court pursuant to 28 U.S.C. § 1254(1).

STATEMENT

A. Nature and Stage of the Proceedings.

Petitioner filed this action in the Northern District of Illinois alleging, *inter alia*, securities fraud under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), in connection with the spinoff of Caremark International, Inc. ("Caremark") by Baxter International Inc. ("Baxter"). C.A. App. 18-45.

On March 26, 1997, the district court granted the defendants' motions to dismiss petitioner's Corrected Second Amended Complaint (the "Complaint") pursuant to Fed. R. Civ. P. 12(b)(6). The district court held that on the facts alleged in the Complaint, petitioner neither purchased nor sold securities when she received the shares of Caremark stock that were distributed to her in the spinoff.

Accordingly, she could not satisfy the purchaser-seller requirement of *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), and failed to state a cause of action under the federal securities laws. Pet. App. 13a.

A unanimous panel of the Seventh Circuit affirmed. Pet. App. 1a-13a. Petitioner did not seek rehearing.

B. The Allegations of the Complaint.

The Complaint alleges that on November 30, 1992, Baxter distributed, or "spun off" all of the outstanding shares of common stock of Caremark to the holders of Baxter's common stock. C.A. App. 20. Prior to the spinoff, Caremark was a wholly-owned subsidiary of Baxter. *Id.* Following the spinoff, Caremark became a publicly held company with its shares listed on the New York Stock Exchange. *Id.* at 22.

Petitioner owned an unspecified number of shares of Baxter common stock at the time of the spinoff and, therefore, received shares of Caremark common stock. C.A. App. 19. Petitioner does not allege that she paid any consideration for her Caremark shares, nor that her consent or any other action on her part was sought or required to effectuate the spinoff. *Id.* at 18-45.

Both before and after the spinoff, Caremark was a health care company engaged in a variety of health care related activities, including non-hospital "alternate site" patient care services, such as home infusion and medication therapies, physical therapy and rehabilitation therapy. *Id.* at 22-23. As part of its business, Caremark entered into agreements with, and paid fees to, physicians and other health care professionals for their services and assistance in treating patients receiving therapies provided by Caremark.

Id. at 25. The Complaint alleges that a potential for abuse, in the form of payments to doctors for referring patients, was inherent in these "fee-for-service" relationships. *Id.* Prior to the spinoff, in August 1991, the Office of the Inspector General for the Department of Health and Human Services (OIG) began a review of Caremark's fee-for-service relationships for potential violations of the Medical Referral Payments Law ("MRPL"), 42 U.S.C. § 1320a-7b, which prohibits payments to induce the referral of patients covered by federal insurance programs such as Medicare and Medicaid. C.A. App. 25-26.

In connection with the spinoff, Baxter and Caremark jointly distributed an Information Statement to Baxter's shareholders. *Id.* at 25. The gravamen of the Complaint is that the Information Statement contained false and misleading representations and omissions regarding Caremark's fee-for-service agreements with physicians and hospitals. *Id.* at 18-19, 25-39. More specifically, petitioner claims that the Information Statement failed to disclose that Caremark's arrangements with some physicians and hospitals were actually payments for the referral of patients in violation of the MRPL, as subsequently charged in an August 4, 1994 federal indictment of Caremark, several Caremark employees, and others. *Id.* at 30-38.

Petitioner also asserts that the Information Statement misrepresented Baxter's reasons for the Caremark spinoff. The Information Statement explained that the primary purpose of the spinoff was to eliminate a developing strategic competitive conflict between hospital customers of Baxter's hospital supply business and Caremark's alternative site patient care business. *Id.* at 28-29. The Complaint alleges that "one reason" for the spinoff was to conceal Caremark's ongoing violations of the MRPL. *Id.* at 29. In her petition and her briefs below, petitioner has expanded on this

allegation, and now contends that Baxter management's entire purpose for the spinoff was to distance itself from the fraud at Caremark by "tranfer[ring] responsibility" from itself to "Caremark's management and . . . shareholders." Pet. 4. Finally, petitioner asserts (without any supporting allegations in her Complaint) that Baxter also misrepresented the purpose of the spinoff to the SEC in order to induce the issuance of a no-action letter. *Id.* at 4-5.

C. The Opinion of the Court of Appeals.

In an opinion by Chief Judge Posner, the court of appeals found "a lot" wrong with petitioner's case. Pet. App. 4a.

The court first held that petitioner failed to meet the threshold requirement under section 10(b) of having purchased or sold securities because she made no investment decision in the Caremark spinoff. Pet. App. 5a-6a. Rather, petitioner and the class she seeks to represent "simply received one share of Caremark stock for every four shares they owned of Baxter." Pet. App. 6a. They "had no choice" whether to participate in the transaction. *Id.* Therefore, "[t]hey no more 'bought' Caremark stock than the recipient of a stock dividend — which the petitioner concedes the distribution of Caremark stock was — buys the stock that he receives as a dividend." *Id.*

The court of appeals also rejected petitioner's argument that her participation in the spinoff should be deemed a purchase or sale under the judicially-created "fundamental change" doctrine. The court questioned the soundness of the fundamental change doctrine, but held that it did not apply in any event because the change worked by the Caremark spinoff in the nature of petitioner's investment was not "fundamental" within the meaning of the doctrine:

"After the [spinoff] the class members owned the same proportion, carrying the same rights, of the same pool of assets." Pet. App. 9a-10a. In addition, the court of appeals held that petitioner could neither satisfy the reliance element of a section 10(b) cause of action nor establish loss causation. Pet. App. 6a-8a, 12a.

For all of these reasons, the court affirmed the dismissal of the Complaint.

REASONS FOR DENYING THE PETITION

At bottom, this is "a lawsuit over the wisdom of the spinoff." Pet. App. 10a. For a variety of reasons, such a claim is not cognizable under the federal securities laws. The Seventh Circuit's decision affirming dismissal of the suit is fully consistent with the law in other circuits.

The only reported case to consider the application of the purchaser-seller requirement to a shareholder's receipt of securities in a spinoff reached the same conclusion as the court of appeals below. *Rathborne* v. *Rathborne*, 683 F.2d 914 (5th Cir. 1982). Petitioner strains to create the appearance of a circuit split by misconstruing cases dealing with fundamentally distinct transactions, and by picking wits with subsidiary issues in the Seventh Circuit's opinion. None of the issues argued in the petition merits the attention of this Court.

I. THE ONLY OTHER CIRCUIT DECISION ON POINT AGREES THAT THE RECEIPT OF SHARES IN A SPINOFF IS NOT A PURCHASE OR SALE OF SECURITIES.

Whether section 10(b) applies to a shareholder's receipt of shares in a spinoff has been considered in only one

prior reported case. Sixteen years ago, in *Rathborne* v. *Rathborne*, the Fifth Circuit held that the shareholder in such a spinoff did not purchase or sell securities and that the fundamental change doctrine did not apply because he "continued to possess the same proportionate interests in the same enterprises, with the same assets, and the same prospects" after the spinoff as before. 683 F.2d at 920. In the decision below, the Seventh Circuit expressly relied on and agreed with *Rathborne*, its holding, and its reasoning. Pet. App. 9a-10a. There is, in short, no circuit split.

Petitioner does not mention *Rathborne*. Instead, petitioner argues that the court of appeals' decision is in conflict with two early 1970s cases that, she asserts, held "that a spinoff was a sale." Pet. 7, citing *International Controls Corp.* v. *Vesco*, 490 F.2d 1334 (2d Cir.), cert. denied, 417 U.S. 932 (1974), and *SEC* v. *Datronics Eng'rs, Inc.*, 490 F.2d 250 (4th Cir. 1973), cert. denied, 416 U.S. 937 (1974). Neither of these cases is applicable here. Both involved fundamentally distinct types of transactions, and neither one considered or decided the question raised by this case, which is whether a shareholder's receipt of securities in a spinoff is a purchase or sale for purposes of section 10(b).

Datronics and its companion case, *SEC* v. *Harwyn Indus. Corp.*, 326 F. Supp. 943 (S.D.N.Y. 1971), on which petitioner also relies (Pet. 8), upheld the power of the SEC to regulate an abusive practice known as "going public through the backdoor" as a "sale" of securities for purposes of the registration requirements of section 5 of the Securities Act of 1933, 15 U.S.C. § 77e. The transactions at issue in those cases were not simply spinoffs; rather, spinoffs were used as one in a series of steps to create public markets for the securities of new companies with little or no value while evading the registration requirements of the 1933 Act. *See*

Spin Offs and Shell Corporations, SEC Release No. 33-4982, 1969 WL 4916, at *2 (July 14, 1969).

Datronics and *Harwyn* are distinguishable on numerous grounds. As the district court recognized, neither case involved a private plaintiff and, accordingly, neither case speaks to whether a private plaintiff who received shares in a spinoff is a purchaser or seller of securities. Pet. App. 24a. The district court also explained that, while *Datronics* and *Harwyn* involved transactions in which "the spun-off corporation was acquired for the sole purpose of spinning it off . . . [,] Caremark was neither recently acquired by Baxter nor acquired with the sole purpose of spinning it off in an end-run around the 1933 Act registration process." Pet. App. 25a. Petitioner did not dispute this conclusion in the court of appeals and does not dispute it here. Finally, the Court of Appeals distinguished *Datronics* on yet another ground: that it involved transactions whose "only purpose had been to evade the registration requirements of the securities laws," whereas "[t]here is no claim here that the failure to register the Caremark shares violated any such requirement." Pet. App. 11a.[1]

International Controls did not consider the question presented by this case either, because it also was not a suit by a shareholder who received shares in a spinoff. Rather,

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[1] Neither the *Datronics* court nor the SEC believed that their positions would apply to "more conventional spin offs," such as the Caremark spinoff. SEC Release No. 33-4982, 1969 WL 4916, at *2; *Datronics*, 490 F.2d at 255 ("the opinion of the court may not be broadly enough read to cast doubt upon the legitimate business acquisition of one company by another ... although a market for securities spun off as a consequence of the transfer may be thereby created") (Widener, C.J., concurring).

the question there was whether the corporation could state a cause of action against the notorious financial fugitive Robert Vesco, who had fraudulently induced the corporation's board to spin off a subsidiary that owned valuable assets and over which Vesco was able to assume control after the spinoff. 490 F.2d at 1342. The Second Circuit found that the corporation made an investment decision regarding "whether to retain or spin-off [the] subsidiary," with regard to which "the corporation [was] well deserving of and entitled to the protection of § 10(b)." *Id.* at 1345. Petitioner does not cite, and we are not aware of, any case that has applied or extended *International Controls* beyond the unique facts under which it arose. Indeed, we are unaware of any case that has followed *International Controls* at all in the quarter century since it was decided.

The dearth of spinoff cases in the last 25 years demonstrates that *Datronics*, *Harwyn* and *International Controls* have been uncontroversial and appropriately confined to their particular facts. Those facts have no application to this case, and these cases therefore do not present any circuit conflict. The only case on all fours with this one is *Rathborne* v. *Rathborne*, which the Seventh Circuit squarely followed. Accordingly, there is no reason for this Court to grant review.

II. THE COURT OF APPEALS CORRECTLY HELD THAT PETITIONER DID NOT PURCHASE OR SELL SECURITIES IN THE CAREMARK SPINOFF.

In addition to the fact that this case presents only a rarely-litigated issue on which the circuits are in agreement, the Seventh Circuit's decision is undoubtedly correct. The court of appeals held that petitioner was not a purchaser or seller of securities in the Caremark spinoff on two principal

grounds: first, that she made no investment decision in the spinoff, and, second, that the spinoff did not work a "fundamental change" in the nature of her investment. Each of these grounds is correct and supports the judgment below.

Chief Judge Posner held that the absence of an investment decision takes this case outside the basic purposes of the federal securities laws. Pet. App. 6a. "Those laws create a remedy . . . for someone who is induced by ('relied on,' the courts usually say) a misrepresentation or misleading omission to buy or sell a stock." *Id.* "This presupposes that the someone had a choice, a choice distorted by the fraud." *Id.* (citations omitted). In other words, it presupposes that the plaintiff made an investment decision in the challenged transaction. *See also Blue Chip Stamps*, 421 U.S. at 730-49 (explaining that the purchaser-seller requirement ensures that plaintiffs in section 10(b) cases are investors who are induced to make an investment decision in reliance on a fraud).

Here, petitioner made no investment decision. She does not and cannot allege that her consent was required for the spinoff or that she had any choice whether to participate in it. Rather, her Caremark shares were distributed to her automatically by virtue of her status as a Baxter shareholder. Her claim is therefore outside the ambit of section 10(b), because she "cannot have been induced by the alleged fraud to buy or sell any securities . . . ." Pet. App. 6a.[2]

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[2] Petitioner argued below that she was induced by the Information Statement to forego suing in state court to enjoin the Caremark spinoff. But this was not an *investment* decision to purchase or sell securities. Rather, it was a *litigation* decision concerning state law questions of the rights of shareholders and their corporate fiduciaries. *See* Pet. App. 6a-7a.

Petitioner takes issue with this portion of the court of appeals' analysis, asserting that the court "held that reliance is the *sine qua non* of an action under section 10(b) and of a 'sale.'" Pet. 9. But this misstates the court's decision, which did not rest on the investment decision analysis alone. Rather, the court went on to consider and reject petitioner's arguments under the "fundamental change" doctrine on their merits. In dicta, Chief Judge Posner questioned the analytic soundness of the fundamental change doctrine, which is inconsistent with the requirement of an investment decision, but that issue is not presented here because the court held that the doctrine does not apply to the facts of this case.

The fundamental change doctrine, articulated in a line of Fifth Circuit cases, orginates from the Second Circuit's decision in *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967), that a plaintiff whose shares were converted in a squeeze-out merger into the right to receive cash could sue under section 10(b) as a "forced seller." *See 7547 Corp.* v. *Parker & Parsley Dev. Partners*, 38 F.3d 211, 226-27 (5th Cir. 1994) (discussing development of the fundamental change doctrine). The doctrine applies when "[an] investor's interest in a company is fundamentally altered through [forced participation in] a merger, acquisition or liquidation." *Id.* at 226.

As we have already noted, the Fifth Circuit, where the fundamental change doctrine is most highly developed, squarely has held that it does not apply to a spinoff in which the plaintiff "continued to possess the same proportionate interest in the same enterprises, with the same assets and the same prospects" after the transaction as before. *Rathborne*, 683 F.2d at 920. In nearly identical reasoning, Chief Judge Posner held the doctrine does not apply to this case, because

> there [was] no exchange, no forced exit from the corporation, but merely the receipt by [Baxter's] shareholders of additional stock. Only the form in which the members of the class owned Baxter's assets was changed; it was changed from stock in one corporation to stock in two corporations. After the change the class members owned the same proportion, carrying the same rights, of the same pool of assets. Before their ownership interest was denominated in shares of Baxter; after, in shares of Baxter and Caremark; the interest itself — the amount of assets owned by the members of the class — was unchanged.

Pet. App. 9a-10a. Whatever the term "fundamental" may mean, as a matter of both sound policy and "economic reality" (*Rathborne*, 693 F.2d at 920), it does not encompass a transaction that, as here, merely repackages a security holder's existing interests in existing enterprises.

Petitioner suggests that this reasoning is akin to saying that "a headless man is the 'same' as a man with his head attached." Pet. 12. Petitioner's metaphor may reveal more clearly than anything else why her case does not belong in federal court. Her grievance with the Caremark spinoff is that Baxter's management improvidently — and purportedly for self-interested motives — severed Caremark from Baxter at a time when Caremark was not properly equipped to go it alone, resulting in lost synergies to Baxter and business reverses to Caremark that would have been less serious if Caremark had remained part of the larger combined company. But neither bad business decisions nor the failure to disclose the reasons they are bad amount to securities fraud. *Santa Fe Indus., Inc.* v. *Green*, 430 U.S.

462, 477-80 (1977) ("instances of corporation mismanagement . . . in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary" are outside the scope of section 10(b)). Petitioner's remedy, if any, is a state law suit for breach of fiduciary duty, not a federal claim for securities fraud.

III. THE SEVENTH CIRCUIT'S DISAGREEMENT WITH *GOLDBERG* v. *MERIDOR* DOES NOT AFFECT THE OUTCOME OF THIS CASE.

Petitioner also argues that this Court should grant certiorari because the court of appeals rejected the Second Circuit's holding in *Goldberg* v. *Meridor*, 567 F.2d 209 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978). Pet. 11; *see* Pet. App. 6a-7a. This argument is meritless; the Seventh Circuit's discussion of *Goldberg* is dicta that does not affect the outcome of the case.

In *Goldberg*, the Second Circuit held that the reliance element of a section 10(b) cause of action (or the materiality element, which substitutes for reliance in an omissions case) may be supplied by allegations that the plaintiff was induced to forego a state court remedy. 567 F.2d at 218-21. The Seventh Circuit does not follow *Goldberg* because it "would allow every complaint about the mismanagement of a corporation that issues securities subject to federal securities law to be shoehorned into federal court on the theory that management had defrauded the shareholders by concealing their mismanagement." Pet. App. 7a.

But even if the Seventh Circuit followed *Goldberg*, that would not change the result in this case. The Seventh Circuit went on to hold that petitioner could not maintain this suit "even if, had it not been for the alleged fraud, [she] would have succeeded in getting the spinoff enjoined." *Id.*

This is "because the fraud did not cause the loss of investment value of which she complains — the scrape over Medicare and Medicaid did that." *Id.* In other words, *Goldberg* would allow petitioner only to show "transaction causation," but not "loss causation," which also is necessary to state a claim under section 10(b). *Id.* at 8a (citing cases). The petition does not seek review of this alternative holding. As a result, the disagreement over *Goldberg* is immaterial to the outcome of this case and provides no basis for granting certiorari.

IV. THE COURT OF APPEALS' APPLICATION OF RULE 12(B)(6) DOES NOT WARRANT REVIEW.

Finally, petitioner argues that Fed. R. Civ. P. 12(b)(6) and this Court's decision in *Conley* v. *Gibson*, 355 U.S. 41 (1957), required the court of appeals to credit the conclusory allegation in her Complaint that the spinoff did work a "fundamental change" in her investment. Pet. 12. This is not a basis for this Court's review. Petitioner does not and could not argue that the legal principles established by Rule 12(b)(6) and *Conley* v. *Gibson* are in any way unsettled or the subject of a circuit split. Rather, her contention is simply that the Seventh Circuit misapplied well-settled law in reviewing this particular complaint — hardly a cert-worthy issue.

What is more, petitioner's argument is groundless. The problem is that the facts alleged in the Complaint do not support — indeed, they contradict — the conclusory allegation of fundamental change. Instead, the Complaint shows that the spinoff merely repackaged interests that petitioner already owned in Baxter and Caremark, as a wholly-owned subsidiary of Baxter, from a single security into two separate ones, such that petitioner continued to

possess the same proportionate interests in the same underlying corporate assets after the spinoff as before. C.A. App. 19-20, 22. As a result, petitioner has "pleaded [her]self out of court." *Thomas* v. *Farley*, 31 F.3d 557, 558-59 (7th Cir. 1994). She cannot save her claim by "plead[ing] a legal conclusion that if consistent with the facts would establish [her] right to relief [*i.e.*, the conclusion that the spinoff was a fundamental change], for [she] has shown that it is inconsistent with the facts." *Id.* at 559. Thus, there is no need for review on this ground either.

CONCLUSION

The petition for certiorari should be denied.

Respectfully submitted.

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